CHINA TAX ALERT

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China State Council publishes new policy framework on Special Customs Supervision Zones

Regulations discussed in this issue:

- Guidelines to Facilitate the Scientific Development of the Special Customs Supervision Zones (Guo Fa [2012] No. 58)
- Notice of Consistent Enforcement on Repair Business within the Special Customs Supervision Zones (Shu Jia Fa [2012] No. 455)

On 27 October 2012, the State Council issued a new policy directive that will shape the future of Special Customs Supervision Zones (SCSZ) in China. Known as Guo Fa [2012] No. 58, this new roadmap strives to rationalise and integrate various SCSZ and align them with China's evolving economic objectives while simultaneously leveraging the efficiencies and advantages offered by modern information and inventory management technology.

As the guidelines are written in the form of a general, overarching policy framework, we expect that China Customs and other relevant authrorities will issue more concrete implementation measures in the coming months. Regardless of when these implementation measures will take place, it is certain that a shift in the way SCSZ operate is slowly underway.

SCSZ issues

The supervised zones are closely monitored by Customs, particularly the movement of goods and materials that cross borders between the SCSZ and the inland Customs territory, and between the SCSZ and overseas. Generally the tax and duty treatment are similar across the various SCSZ. However, in some cases (especially if traditional Free Trade Zones (FTZ) are involved), companies may encounter different results particularly in the timing of Export VAT refunds and the determination of the dutiable tax base of products brought into domestic consumption. These complexities have caused confusion and unwarranted costs for companies in the form of penalties for non-compliance or an unexpectedly high VAT burden.

Furthermore, each SCSZ has a different set of limitations on the kinds of activities that can be performed within their premises. Companies in a Bonded Logistics Park (BLP), for example, are unable to perform manufacturing activities reserved for companies in FTZ. The treatment of repaired items brought into and removed from SCSZ has also not been clearly defined in the regulations.

All of these concerns have led to calls for a more integrated and rationalised SCSZ regime.

Salient points

In response to the need for a more integrated approach to SCSZ, the Chinese government has moved to address these issues within the framework of Guo Fa [2012] No. 58. In summary, the policy aims to:

- **Rationalise and integrate –** Current SCSZ will be enhanced and brought up to standards set for Comprehensive Bonded Zones (CBZ), which currently receive the highest level of incentives and cover the most number of permitted business activities. SCSZ established in the future are similarly expected to follow the CBZ model.

- **Promote 'greener' and higher value-added activities –** The new policy encourages companies in the high-tech and research and development sectors to invest and reside in CBZ. Other preferred activities include product design, brand creation, the manufacture of high-value and more sophisticated 'core' parts (as opposed to peripherals and accessories), and logistics. It also hints at the promotion of green or environmentally friendly products and technologies. Overall, there is a strong emphasis on attracting investments that would generate solid economic value and avoiding 'blind' investments that have no clear economic purpose.

- **Automate and increase efficiency –** Customs authorities in charge of supervising SCSZ and the companies under their supervision may be required to automate their processes to expedite the computation of duties/taxes and facilitate cargo clearance. The policy makes direct reference to advanced information technology and management tools, which could mean the installation of specific Enterprise Resource Planning (ERP) interface software and hardware such as radio frequency identification (RFID) devices that are able to track and match physical inventory to shipping documents.

Implementation starting with repair service enterprises

The bonded operations of repair service enterprises in SCSZ has been an area of uncertainty for a significant period of time due to a lack of clear operating principles regarding how they are to be undertaken from a Customs perspective. Although approvals to conduct repairs for electrical and machinery products made in and exported from China have been granted by Customs in the past, the repair of foreign products has remained relatively unclear due to administrative challenges (such as inventory and scrap management).

As an initial step towards clarifying issues around these types of activities, China Customs recently released an internal memo, Shu Jia Fa [2012] No. 455, which may be regarded as one of the first implementation measures to carry out the objectives of Guo Fa [2012] No. 58.

Shu Jia Fa [2012] No. 455 does not lift the existing restrictions; it adds explanatory details and suggests an integrated approach for the treatment of repair items in SCSZ. Shu Jia Fa [2012] No. 455 specifically requires repair service enterprises within SCSZ to meet the following minimum qualifications:

- Maintain a computer management system that meets the Customs supervision requirements regarding the enabling of online data exchange via the Customs network

- Adopt an internal management system that can distinguish, down to the level of part numbers, goods for repair and parts to be used for repairs from both local and overseas markets

- Be able to dispose of discarded damaged parts, scrap and leftover parts in accordance with prevailing regulations.

Customs has clarified that repair items must be declared as 'goods for repair' while materials used for repair, discarded parts, scrap, and leftovers should be declared according to the pertinent 'processing trade' procedures.

It is also important to note that Customs will implement detailed and strict monitoring systems that will review companies' raw data of part numbers, as well as declared customs items.

Repaired goods that are returned from SCSZ to the local market will be subject to customs duty and VAT in accordance with the rules and regulations governing 'export goods for repair'. Therefore, duties and VAT will only be assessed on the cost of the repair and the value of any additional materials used for the repair. Goods brought from the local market into SCSZ will not be eligible for a VAT refund. If it is discovered that goods brought into SCSZ are beyond repair, then the goods should be removed and returned to their original source (local or overseas) in their original state.

KPMG observations

Guo Fa [2012] No. 58 confirms previous observations that China is intent on increasing the value of its manufacturing operations and reducing its overall carbon footprint. This is a welcome development for companies engaged in renewable energy, scientific research, and logistics that are currently operating in, or are interested in establishing operations, in SCSZ to capitalise on tax and duty incentives. However, it also sends a subtle signal to companies that are currently running traditional manufacturing operations. These companies will need to innovate, upgrade or diversify their product/service lines, in accordance with preferred operations in the new guidelines, in order to avoid the risk of being disqualified from receiving the benefits of SCSZ in the future. Now is the ideal time for companies to engage in professional consultation regarding possible joint ventures, new investments, financing options, and the most tax efficient means of carrying these out.

Businesses located in SCSZ that currently process purchase and/or sales channels from overseas, local non-SCSZ and SCSZ markets are advised to set aside resources for investment in ERP systems and/or ancillary programs and equipment. Repair service enterprises are now obligated to meet this standard and it can be assumed that other industries in SCSZ may also be required to meet the same standard in the future. It is essential for companies to take an approach that combines Tax and Information Technology (IT) Advisory in identifying the right product with configuring the appropriate ERP modules for their operations.

As it will take some time before the objectives of Guo Fa [2012] No.58 are fully realised, companies have ample opportunity to plot their future strategies. As the government is moving towards a reduction of existing restrictions and the harmonisation of procedures, this opens an even wider range of strategic and tax planning options. Companies, especially those in the repair business, are advised to consult professional tax advisers. Advisors can assist with preparing a proper roadmap beginning with a review of current operations, products, and location in order to identify opportunities to streamline, innovate and/or relocate.

KPMG cutting through complexity

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